

Message Text

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ACTION ARA-20

INFO OCT-01 AF-10 EUR-25 EA-11 NEA-14 ISO-00 AEC-11 AID-20

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FPC-01 H-03 INR-10 INT-08 L-03 NSAE-00 NSC-07 OMB-01

PM-07 RSC-01 SAM-01 SCI-06 SP-03 SS-20 STR-08 TRSE-00

PA-04 PRS-01 USIA-15 IO-14 AECE-00 DRC-01 /243 W

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FM AMEMBASSY CARACAS

TO SECSTATE WASHDC 3952

INFO AMEMBASSY BEIRUT

AMEMBASSY JAKARTA

AMEMBASSY JIDDA

AMEMBASSY KUWAIT

AMEMBASSY LAGOS

AMEMBASSY LIMA

AMEMBASSY LONDON

AMEMBASSY PORT OF SPAIN

AMEMBASSY QUITO

AMEMBASSY TEHRAN

AMEMBASSY TRIPOLI

AMEMBASSY VIENNA

AMCONSUL DHAHRAN

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E.O. 11652: N/A

TAGS: ENRG, XX

SUBJECT: FEDERAL ENERGY OFFICE AUDIT OF OIL IMPORT PRICES

1. U.S. FEDERAL ENERGY OFFICE, ACCORDING TO PRESS REPORTS, HAS
PUBLISHED A PROPOSAL THAT WOULD CLARIFY REGULATIONS PERTAINING
TO COST INCREASES, FOR IMPORTED PETROLEUM AND PRODUCTS, WHICH OIL COM-

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PANIES ARE PERMITTED TO PASS THROUGH TO U.S. CONSUMERS. PROPOSAL

REPORTEDLY "WOULD DISALLOW SOME OF COSTS OIL COMPANIES HAVE CLAIMED FOR CRUDE AND REFINED PRODUCTS PURCHASED FROM OVERSEAS AFFILIATES," AND COULD RESULT IN PRICE ROLLBACKS IN U.S. RATIONALE FOR PROPOSAL, AS CITED BY PRESS, IS THAT "INTERNATIONAL COMPANIES CAN USE 'TRANSFER PRICE' BETWEEN THEIR INTERNATIONAL AND U.S. AFFILIATE TO JACK UP THEIR OVERALL PROFIT TO DISADVANTAGE OF AMERICAN CONSUMER." REMEDY IS SAID TO BE IN REQUIRING OIL COMPANIES TO BASE TRANSFER PRICES ON RECENT ARMS LENGTH SALES TO THIRD PARTIES.

2. BASING PERMISSIBLE IMPORT COSTS ON ARMS LENGTH TRANSACTIONS WITH THIRD PARTIES (IF LEGITIMATE REPRESENTATIVE TRANSACTIONS EXIST IN EACH CASE) COULD BE AN ANSWER DURING PERIODS OF NORMAL MARKET

SITUATIONS, BUT DURING RECENT ARAB BOYCOTT PRICES AT WHICH THIRD PARTY SALES TOOK PLACE BORE NO RELATIONSHIP TO PRICES THAT COMPANIES IMPORTING THEIR OWN CRUDE OIL COULD HAVE LEGITIMATELY PASSED ON TO U.S. CONSUMERS UNDER RUBRIC OF INCREASED COST. COST INCREASES DURING ARAB BOYCOTT WERE VERY SUBSTANTIAL, AND HAD TO BE PASSED ON TO CONSUMERS, BUT THEY WERE MUCH LESS SUBSTANTIAL THAN PRICE INCREASES FOR THIRD PARTY SALES AND (IT WOULD APPEAR FROM INDUSTRY PROFIT FIGURES) LESS THAN INCREASES IN "TRANSFER PRICES".

3. PRESUMABLY, FEDERAL ENERGY OFFICE WILL BE INTERESTED IN UNCLASSIFIED DATA PERTAINING TO COST OF VENEZUELAN OIL DURING ARAB BOYCOTT IN CONNECTION WITH ITS CURRENT EFFORTS TO DETERMINE WHAT COSTS OIL COMPANIES COULD LEGITIMATELY HAVE PASSED ON TO U.S. CONSUMERS DURING THAT PERIOD. THIS MESSAGE THEREFORE SUMMARIZES RELEVANT COST ELEMENTS AND ATTEMPTS TO ILLUSTRATE BY USE OF A HYPOTHETICAL EXAMPLE, BASED ON AVAILABLE UNCLASSIFIED DATA ABOUT PRICES, IMPLICATIONS OF VARIOUS POSSIBLE INTERPRETATIONS OF WHAT CONSTITUTES "COST" OF IMPORTED OIL. THIS IS CLEARLY AN IMPORTANT QUESTION BECAUSE PRICE CONTROL RELIEF GIVEN TO OIL COMPANIES WAS BASED ON CONCEPT OF PASSING ON ONLY INCREASES IN COST OF IMPORTED OIL; AND ALSO BECAUSE, DEPENDING ON WHAT CONCEPT OF COST WAS USED, OIL COMPANIES COULD EITHER HAVE MAINTAINED THEIR PROFIT MARGINS AT HISTORICAL PREVAILING LEVELS OR COULD HAVE BEEN PERMITTED TO INCREASE MARGIN BY ROUGHLY 400 PERCENT AS DATA WILL SHOW.

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4. FOLLOWING ARE RELEVANT UNCLASSIFIED DATA (FROM PETROLEUM INTELLIGENCE WEEKLY) SHOWING COST AND PRICE INCREASES AFFECTING VENEZUELAN OIL FOR THE YEAR ENDING JANUARY 1974:

- 1) PRICE OF VENEZUELAN CRUDE OIL 1/1/73 (EQUALS TRV) \$3.09/BBL
- 2) INCLUDES TAX PAID TO GOV OF (\$1.62)
- 3) ALSO INCLUDES OPERATING COST OF (\$0.51)
- 4) AND MARK-UP OF ABOUT (\$0.96)

5) TAX PAID TO GOV 1/1/74	\$8.20
6) TAX INCREASE (5-2)	\$6.58
7) TAX PAID COST OF VENEZ. CRUCE 1/1/74 (3PLUS5)	\$8.71
8) ASSUMED PRICE OF VENEZ. CRUCE 1/1/74 BASED ON COST (PROFITS ASSUMED CONSTANT) (1PLUS6)	\$9.67

5. AS ABOVE CALCULATION SHOWS, AN OIL COMPNAY SHIPPING 26 GRAVITY VENEZUELAN OIL TO U.S. MARKET IN JANUARY 1974 COULD JUSTIFY PASSING THROUGH TO U.S. CONSUMER A COST INCREASE OF \$6.58 ABOVE JANUARY 1973 PRICE OF \$3.09 (PLUS OR MINUS ANY CHANGE IN SHIPPING COST). THUS, ITS TOTAL PRICE FOR PRICE CONTROL PURPOSES SHOULD HAVE BEEN IN NEIGHBORHOOD OF \$9.67 AT DOCKSIDE IN VENEZUELA. (FREIGHT OF ABOUT 41 CENTS/BARREL WOULD HAVE TO HAVE BEEN ADDED TO GET OIL TO US EAST COAST).

6. IF, INSTEAD OF USING A CALCULATION OF ACTUAL COST INCREASES PAID BY OIL COMPANIES, U.S. PRICE CONTROL AUTHORITIES BASED IMPORT COSTS, FOR APERIOD OF MARKET DISRUPTION SUCH AS THAT DURING ARAB BOYCOTT, ON TRANSFER PRICES BETWEEN AFFILIATES OR ON THIRD PARTY TRANSACTIONS, QUITE A DIFFERENT SET OF FIGURES COULD EMERGE. TRANSFER PRICES, OF COURSE, CAN BE PRACTICALLY ANY PRICES OIL COMPANIES

WISH TO USE FOR TRANSACTIONS WITH AFFILIATED COMPANIES.

7. ONE LOGICAL TRANSFER PRICE FOR VENEZUELAN CRUDE MIGHT BE TAX REFERENCE VALUE (TRV), WHICH IS MINIMUM VALUE OF CRUDE SET BY VENEZUELAN AUTHORITIES FOR PURPOSES OF CALCULATING AMOUNT OF TAX DUE. TRV ON VENEZUELAN 26 GRAVITY CRUDE IN JANUARY 1974 WAS \$13.67, WHICH IS ACCEPTED AS A "COST"BY U.S. PRICE CONTROL AUTHORITIES

WOULD HAVE INCREASED OIL COMPANY PROFIT MARGINS BY AN ADDITIONAL \$4 PER BARREL. BASING PRICES ON "ARMS LENGTH" TRANSACTIONS OCCURING DURING SAME PERIOD OF CHAOTIC MARKET CONDITIONS COULD HAVE

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LED TO EVEN HIGHER CALCULATIONS OF "COST"THAN USING TRV'S AS A TRANSFER PRICE. SALES WERE BEING MADE IN AFRICA AND MIDDLE EAST IN JANUARY 1974 AT PRICES RANKING UPWARD FROM \$14 PER BARREL. ALGERIAN OIL, FOR EXAMPLE, WAS SOLD TO ALL OF LARGEST OIL COMPANIES OPERATING IN VENEZUELA DURING FIRST QUARTER OF 1974 AT PRICE OF \$14 PER BARREL, WHICH WHEN ADDED TO FREIGHT DIFFERENCES TO

U.S. EAST COAST EQUATES TO
A PRICE OF ABOUT \$14.40 FOR A COMPARABLE VENEZUELAN OIL.

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8. THUS, IN THIS EXAMPLE, USING VENEZUELAN OIL, THERE ARE THREE
DIFFERENT CONCEPTS OF COST OF OIL IMPORTED INTO U.S. EACH OF WHICH
YIELDS A DIFFERENT RESULT IN TERMS OF PRICE TO BE PAID BY U.S.
CONSUMER AND PROFIT TO BE MADE BY OIL COMPANY:

METHOD	OIL IMPORT PRICE	COMPANY MARK-UP
(1) TRUE COST INCREMENT METHOD	\$ 9.67	\$0.96
(2) TRANSFER COST AT TRV	\$ 13.67	\$4.96
(3) ARMS LENGTH SALE PRICE	\$ 14.40	\$5.73

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9. CONTROVERSY NOW GOING ON BETWEEN FEDERAL ENERGY OFFICE AND OIL COMPANIES OVER WHAT WAS CORRECT METHOD TO USE IN ESTABLISHING COST OF OIL IMPORTED INTO U.S. DURING BOYCOTT APPEARS, ON BASIS OF NEWSPAPER ACCOUNTS, TO INVOLVE QUESTION OF WHETHER COMPANIES SHOULD USE "ARMS LENGTH" SALES PRICES OR TRANSFER PRICES (WHICH COULD BE EITHER HIGHER OR LOWER THAN ARMS LENGTH SALES PRICE). IF SO, DIFFERENCE BETWEEN FEO POSITION AND COMPANY'S POSITION COULD BE RELATIVELY SMALL DEPENDING ON TRANSFER PRICES ACTUALLY USED BY EACH COMPANY. HOWEVER, THERE IS OBVIOUSLY A VERY GREAT DIFFERENCE BETWEEN TRUE COST INCREASES ACTUALLY INCURRED BY COMPANIES OPERATING IN VENEZUELA IN CONNECTION WITH THEIR EXPORTS TO U.S. OF OWNED OIL AND AMOUNT OF VENEZUELAN TAX REFERENCE VALUE. IT WOULD APPEAR THAT UNDER U.S. PRICE CONTROL PROGRAM, WHICH ALLOWED INCREASES IN PRICE ONLY TO OFFSET ACTUAL COST INCREASES, ANY OWNED OIL IMPORTED FROM VENEZUELA AT HIGHER THAN PRICE INDICATED BY "TRUE COST INCREMENT METHOD" (\$9.67 FOR TYPE OF OIL IN EXAMPLE) SHOULD BE SUBJECT TO AN ADJUSTMENT AND CORRESPONDING PRICE ROLLBACK.

10. WHAT IS MOST CLEARLY ILLUSTRATED BY EXAMINING QUESTION OF APPROPRIATE COST BASIS FOR OIL IMPORTED FROM VENEZUELA IS THAT TAX REFERENCE VALUE IS NO LONGER AN APPROPRIATE YARDSTICK. TRADITIONALLY,

OIL COMPANIES HAVE STRIVED TO SELL OIL AT CLOSE TO TAX REFERENCE VALUE, AND HAVE MOST OFTEN SUCCEEDED, FOR IF THEY FAILED TO DO SO THEIR EXPECTED REVENUES SHRANK WHILE THEIR TAXES (WHICH ARE BASED ON TRV(S)) REMAINED CONSTANT. PROBABLY THIS CLOSE RELATIONSHIP BETWEEN TRV'S AND REALIZED PRICES WOULD HAVE CONTINUED IF TRV'S HAD BEEN INCREASED GRADUALLY AND INCREMENTALLY. BUT THE VENEZUELAN GOVERNMENT INCREASED TRV'S BY OVER 400 PERCENT BETWEEN JANUARY 1, 1973

AND JANUARY 1, 1974. AFTER SUCH AN ENORMOUS INCREASE IN TRV'S IF OIL PRICES COULD BE PUSHED UP TO NEW LEVEL OF TRV'S AND HELD AT THAT LEVEL, AND IF SUCH PRICES COULD BE ACCEPTED AS "COST" OF IMPORTED OIL BY IMPORT AUTHORITIES IN VARIOUS IMPORTING COUNTRIES, THEN CLEARLY RESULT WOULD BE TO INCREASE OIL COMPANY MARK-UP BY SAME 400 PERCENT THAT GOVERNMENT OF VENEZUELA HAD INCREASED ITS TAX TAKE.

THUS, UNDER NEW CONDITIONS, APPROPRIATE BASIS FOR IMPORT COST OF OIL FROM VENEZUELA IS COST OF PRODUCTION, PLUS TAXES PAID TO VENEZUELA, PLUS OTHER COSTS, SUCH AS TRANSPORTATION, PLUS COMPANY UNCLASSIFIED

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